

Construction, Engineering and Architecture Services in Azerbaijan: Opportunities for U.S Business Development

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June 2005

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This report provides an overview of commercial and investment opportunities in the Construction sector, focused on the Baku region of Azerbaijan. The report contains snapshot of architecture, construction and engineering services, and snapshot of building products. There is a section "SWOT Analysis of the Azeri Construction market" which provides strengths, weaknesses, opportunities and threats of the market for the U.S. exporter.

2005 witnesses a big boom in residential, commercial and industrial construction in Azerbaijan, overwhelmingly concentrated in its capital, Baku. According to several Azeri construction firms, today's market is more results oriented, time sensitive, and largely rejects low quality materials and workmanship, stock is also a key element for Azeri firms since clients want timely delivery of building materials and services and simply do not want to wait. In the words of the head of one Azeri construction firm: "Azeris do not want to wait they want their renovation done yesterday. That is why in order to maintain good client base, you need to have good inventory and available materials all the time. If you keep large stock you cannot afford many product choices, and with many choices and less stock, you cannot pull in the orders." Thus a key element in the Azeri construction market is a large inventory with broad selection and stock at the same time – a financial challenge and risk for many Azeri construction firms.

Snapshot: Architecture/Construction/Engineering Services

The construction market in Azerbaijan has rapidly evolved from a state controlled monolith to one marked by upstart architectural, design and building firms with a thirst for the latest Western technologies and building materials. The construction sector is still heavily dependent on the development of the oil and gas sector, the backbone of Azerbaijan's economy. The lack of acceptable financing (i.e., bank loans and working capital on reasonable terms) forces Azerbaijani construction companies to rely on private capital. However, for targeted proposals backed by trade financing, there is potential business growth for U.S. firms with interest in this challenging market. Apartment and commercial renovation, construction related to the oil and gas sector, and demand for modern construction equipment and materials are key elements of future market growth, with government estimates of 370% growth in the construction sector in 2006. Large-scale development projects, particularly pre-fabricated housing and warehousing for the oil and gas industry portend huge potential in procurement needs from 2006 to 2007. Project pipelines involving international financial institutions as well as sub-contracted turn-key projects for the international oil consortia in the Caspian region should also be considered. Throughout 2004, there has been a big-construction boom in Azerbaijan, primarily confined to Baku and its environs. Residential construction, whether multi-story, multiple dwelling units, or detached houses, are being built throughout the capital -- almost exclusively with private money. U.S. suppliers are advised to create medium-term buying relationships with leading Azeri construction firms, particularly in the area of security/CCTV systems, automatic gates/garages, windows/doors systems, brick manufacturing equipment, and other area of construction and building materials. For industrial construction, over \$5 billion in procurement opportunities for U.S. oil and gas service firms and subcontractors are expected over the next 3 years in the Caspian region. These opportunities cover mainly subcontracting to oil companies in construction, engineering,

and telecommunication sectors, as well as operational support and supplies (e.g., pre-fabricated housing, warehouses, supply of tools and materials, etc.).

Snapshot: Building Products

According to several Azerbaijani construction firms, today's market is more results-oriented, time-sensitive, and largely rejects low quality materials and workmanship. Stock is also a key element for Azerbaijani firms because clients want timely delivery of building materials and services. Inventory requirements are a financial challenge and risk for construction firms operating in this country. The following construction materials are now considered to be in demand and represent opportunities for U.S. business:

- Assortment of different colored woods for parquet floors and finishing;
- Brick making equipment;
- Ceramic products (tiles, mats, etc.);
- Manufacturing, distribution and sale of paints, coatings and related products for professional, industrial and commercial construction;
- Acrylic for steel structure protection;
- Doors, insulated windows and American style window frames;
- Drywall;
- Heat, ventilation, and air conditioning systems;
- Building materials suited for extreme temperatures;
- Open vinyl sidings;
- U.S. standard sanitary engineering and lighting accessories;
- Varnish paints;
- Various types of wallpapers; and
- Water and sound proofing materials.

These building materials can be found on the Azerbaijani market, mostly sourced out of Turkey, Dubai and Russia and perceived to be of lesser quality. U.S. and European materials enjoy a stronger reputation for quality and, while more expensive, are preferred by Azeri consumers that are in a position to pay. Local sources report that sales are often dependent on product availability in Baku, and that Azeri consumers are often the "cash and carry" type who will rarely suffer long supply lines from the United States or Europe. Long-term leasing of construction equipment also presents opportunities for U.S. construction equipment firms. However, current legislation governing leases does not adequately ensure lessor rights and requires further review. Leasing of earthmovers, bulldozers, small forklifts, etc. -- particularly in support of hydrocarbon production and oil and gas pipelines -- can be a commercially viable business. Leasing will become increasingly prevalent over the 2005-2006 period, when more design and construction sub-contractor tenders are expected to be announced.

State Committee for Construction and Architecture is the main authority responsible for issuing the license for the design of buildings and construction of the Level I and II responsibility in accordance with state standards; search and identification of engineers.

SWOT Analysis of the Azeri Construction Market

Strengths:

1. Need for top quality materials: suppliers should recognize the need for top quality materials, with preference for U.S. and European brand names.
2. Growth likely in the construction market given rapid economic expansion due to the massive international investment in Azerbaijan's oil and gas wealth. Azerbaijan's established oil and gas sector will also continue to expand, opening up new opportunities for construction, engineering and architecture services firms serving oil and gas companies. This opens

opportunities for U.S. suppliers. Some construction equipment suppliers are interested in externally financed multi-functional, turn key production facilities for bricks, tiles, ceramic, window and door manufacturing.

3. No quality local production: some local-made construction materials do not see strong demand, and are simply non-competitive with imported materials
4. Low operating costs, including rent, labor, etc.

Weaknesses:

1. Low purchasing power: Azeri importers often lack strong financial backing. Purchases are based on private capital thus limiting longer-term purchasing power. A letter of credit confirmed by a Western bank is strongly recommended for any initial transaction with an Azeri importer. Although U.S. construction manufacturers enjoy name recognition and a reputation for high quality, the current purchasing power of Azerbaijani entities is very low. However, Azeri importers are also interested in low-cost refurbished equipment.
2. Weak access to reasonably priced credit: as the risk environment is high, banks do not offer very good credit terms. However, some banks have invested in the construction sector because construction companies maintain fixed securable assets, as opposed to smaller trading and service companies.

Opportunities:

1. Following the collapse of the Soviet Union, reforms in the Azeri construction industry led to major restructuring in public and private sectors.
2. Major tenders for onshore and offshore field development as well as pipeline transportation are expected from various oil and gas consortia in the 2005-2006 period.
3. The U.S. Overseas Private Investment Corporation (OPIC – www.opic.gov) is interested in developing commercially-viable projects in Azerbaijan when a U.S. equity investor is present, and U.S. investors should keep this in mind during project planning.
4. The U.S. Export-Import Bank (Ex-Im – www.exim.gov) is interested in developing commercially-viable construction projects in Azerbaijan, and U.S. investors should keep this in mind during project planning.
5. Baku is ideally situated as a business development hub throughout the Caspian region, with air, rail, sea, and road links for market penetration into the Caucasus and Central Asia.
6. All imports under Production Sharing Agreements (PSAs) signed by the International Oil Consortia are VAT and customs duty free.
7. Azeri firms are interested in establishing long-term relations with U.S. suppliers.

Threats:

1. Legislative, customs, and tax environments are challenging and make doing business in Azerbaijan difficult.
2. Third country competition: German, Italian, Japanese, French, Russian, Turkish and Iranian firms have strong market share and developed distribution networks. Russian & Turkish-made equipment is usually purchased by state financed construction companies due to its low price.

Use of Agents and Distributors in Construction Market

Western entrepreneurs and several Azeri firms act as agents for U.S. companies in Azerbaijan, and an increasing number of Azeri trading firms have established solid track records as partners with Western firms. For U.S. firms not willing to commit resources to the relatively small market of Azerbaijan, an agent or representative may be the best initial approach. An agent will work better if the U.S. construction products/services are relatively unknown or untested in the market, as the agent will have limited overhead and inventory to test a new product in the market. For more competitive, developed market segments, a distributor provides the best option for business development. Verifying the financial bona fides of prospective partners is difficult. Given this challenge, potential exporters should plan to visit Azerbaijan to build personal relationships, set up local sales networks, or establish partnerships with local agents or distributors.

In many cases, local companies are distributors for construction materials of different brands. Turkish, European, U.S. and Russian products tend to dominate this price-sensitive market. Several well-established Azeri construction firms have successfully sold U.S. and European equipment and services in Azerbaijan. Due diligence should be done on any potential Azeri distributor before concluding an agreement or shipment given the risks inherent in doing business in Azerbaijan.

U.S. firms looking for opportunities in Azerbaijan should focus on medium-sized, private Azeri firms with a minimum two or three-year track record and credit history. State enterprises are unlikely candidates for performing distribution and sales activities on behalf of U.S. firms; these enterprises lack the resources to cover the costs of maintaining U.S. product inventory for the local market. Azeri firms generally have poor cash flow, given the lack of affordable credit and other structural disincentives. Training and flexible stock/inventory options will help U.S. construction materials and services penetrate the Azeri market. Given Baku's dominance of the market, it is best to work with a Baku-based firm for onward distribution throughout the country.

Price Construct to Baku

U.S. exporters should consider the following when doing a price construct for the Azeri market: customs and import duties are generally about 10-15%, plus 18% VAT. To avoid unnecessary customs delays, let the Azeri importer handle the customs clearance. A 20-foot container of general, non-hazardous cargo from Baltimore to Baku is on average \$4,000-4,500 per container. Transit time is approximately 35-40 days, via Poti, Georgia.

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